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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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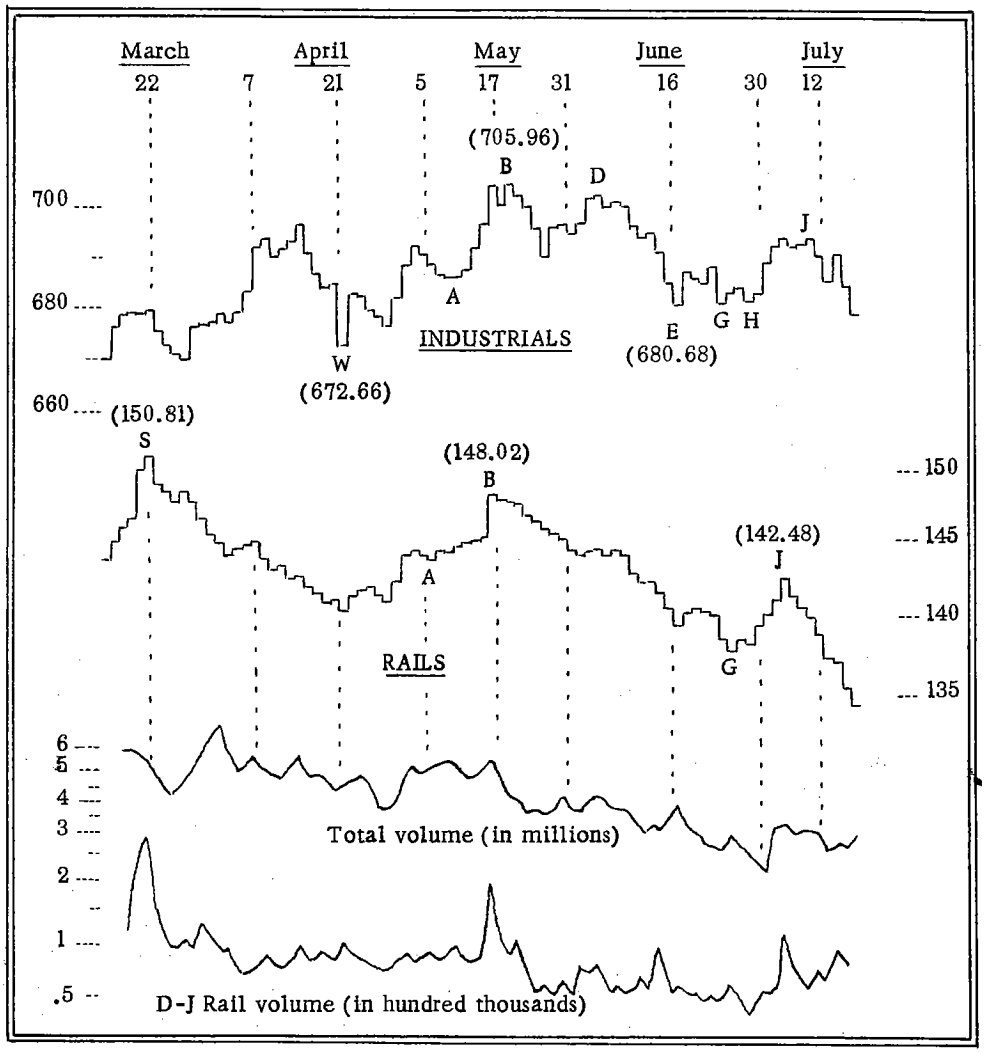
THE MARKET At the June 19 Industrial low (E- 680.68), volume contracted sharply. This implied at least a temporary cessation of selling sentiment. Two further "tests" of the 680.68 level occurred at G and H (each on lower volume). Stocks tend to move in the direction of least resistance. If they will not go down, they will rally. Following the last low at H, Industrials rose to a peak of J (694.27), but as discussed in Letter 149, the poor showing of (1) volume, (2) new highs, (3) the advance-decline ratio, suggested that the rally from H stemmed more from a lack of selling pressure than from any active buying. Letter 149 noted: "The comparison of the May 19 period with the most recent period remains unfavorable and caution is recommended."

After recording a minor peak at J (142.48), Rails embarked on a steady decline to new lows. This performance obviously unsettled the market, and on July 12 Industrials joined in the retreat.

On Tuesday, July 18, Industrials broke through the 680.68 (E) level, rails dropped to their lowest point since January 4 and volume rose to 3.01 million shares. The fact that the 680 level had been tested (and had held) on three previous occasions heightened the bearishness of the penetration.

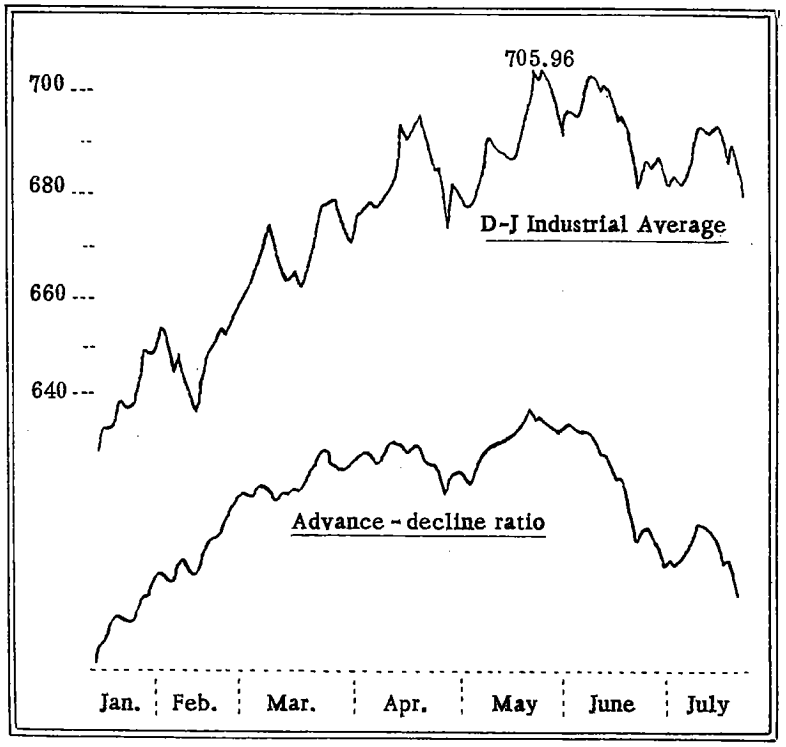
As of this writing, bulls can point to (1) the Dow Theory principle which states that the primary trend continues in force until proved otherwise, and (2) the relatively low volume which has accompanied the entire decline since mid-May. Conversely, bears can point to (1) the succession of three declining Industrial peaks (B, D, J), each recorded on lower volume, (2) the long, persistent decline of the Rails to successive new lows, (3) the confirming action of Industrials, and (4) the poor performance of the advance-decline ratio (which broke to a new low for the move on July 18.)



CONCLUSION: The primary trend is taken to remain bullish. The secondary trend turned bearish when the A points were jointly violated, and this was confirmed on July 18 when Industrials broke the 680.68 level. If Industrials violate point W (672.66) on heavy volume, I, personally will conduct my affairs as if we were in a bear market (all cash and no equity).

ADVANCE-DECLINE RATIO (A-D ratio) The A-D ratio ("breadth") is the ratio of total daily advances and declines on the N. Y. Stock Exchange. This ratio shows the advancing or declining ten-

dencies of all stocks traded on the "Big Board" and is therefore indicative of the movement of the entire market. The relationship of the "blue-chip" D-J Industrial Average and the A-D ratio assumes a particular significance when a disparity or actual divergence occurs between these two indicators.



Letter 141 (April 24) drew attention to the sluggish action of the A-D ratio, and I stated at that time that the market appeared to be "losing its steam." Letter 147 again pointed to the unsatisfactory performance of the A-D ratio, and a chart illustrated the obvious (downward) divergence of the A-D ratio during the early June Industrial advance. Letter 147 concluded: "Either the 'breadth' must improve or the market is in for trouble ahead."

To review the big picture -- the Industrial Average advanced 140 points from October, 1960 to May 19, 1961. During the same period the A-D ratio rallied steadily, recording a peak on May 17. On the subsequent May 19 to June 19 decline, the Industrial Average dropped from 705.96 to 680.68, thereby erasing 18% of all its 1960-61 gains. Over the same period the A-D ratio (see chart) lost 33% of its 1960-61 gains, so that by June 27 the A-D ratio (representing the entire market) had fallen back to approximately the mid-February level (at which time the Industrial Average was 649.)

In other words, between mid-May and mid-June the general market lost almost twice as much ground as the Industrial Average. The relatively poorer performance of the general market was again underscored when, on the most recent Industrial advance (from 680.68 to 694.27), the senior Average recouped 54% of its May-June losses while the A-D ratio regained only 30% of its respective losses. The conclusion: despite the recent "impressive" holding and rallying action of the Industrial Average, the general market has been acting poorly. In my opinion, the A-D ratio has sustained such severe damage that the odds are now heavily against a new high's being recorded on that indicator. This means that regardless of whether or not the Industrial Average eventually rallies to a new high (above 705.96), the majority of stocks on the Exchange have seen their peaks.

During the 1957-59 market advance the A-D ratio started up in October, 1957, and continued almost uninterruptedly higher until April, 1959. Thus, 18 months elapsed before the A-D ratio ran into real trouble. But despite the declining trend in the A-D ratio (beginning in April, 1959), the Industrial Average rose to a new high in August, 1959 (678.10) and again in January, 1960 (685.47).

In the present situation, the A-D ratio has slipped badly "out of gear" after only seven months of steady advance. It would now seem to be a question of how long the Industrial Average can withstand the deteriorating influence of "breadth." I do not believe the lead time in 1961 will be nearly as long as it was in 1959.

RAIL VOLUME Eight months ago a subscriber asked whether I attached any significance to volume in the individual D-J Averages. In Letter 129 I answered by saying that I had never been able to draw any valid conclusions from such studies.

A good bit of time and price action has taken place since then, and in the light of developments over the last six months I have somewhat altered my thinking concerning volume in the individual Averages (volume figures for the D-J Rail and Industrial Average are listed on a daily basis in Barron's and the Wall Street Journal.)

While the following observations are open to interpretation, I believe they are interesting enough to bring to the attention of readers. After the 1957 (recession) lows, the D-J Rail Average rose to a peak of 173.56 (July 8, 1959). That Rail peak has not since been bettered. Volume in the Rail Average was averaging about 80 thousand shares per day during July, 1959. However, near the July Rail peak, volume in the Rail Average read as follows: July 6 - 103 thous. shares, July 7 - 229 thous., July 8 - 242 thous. (this was the high day on the Rail Average), July 9 - 150 thousand.

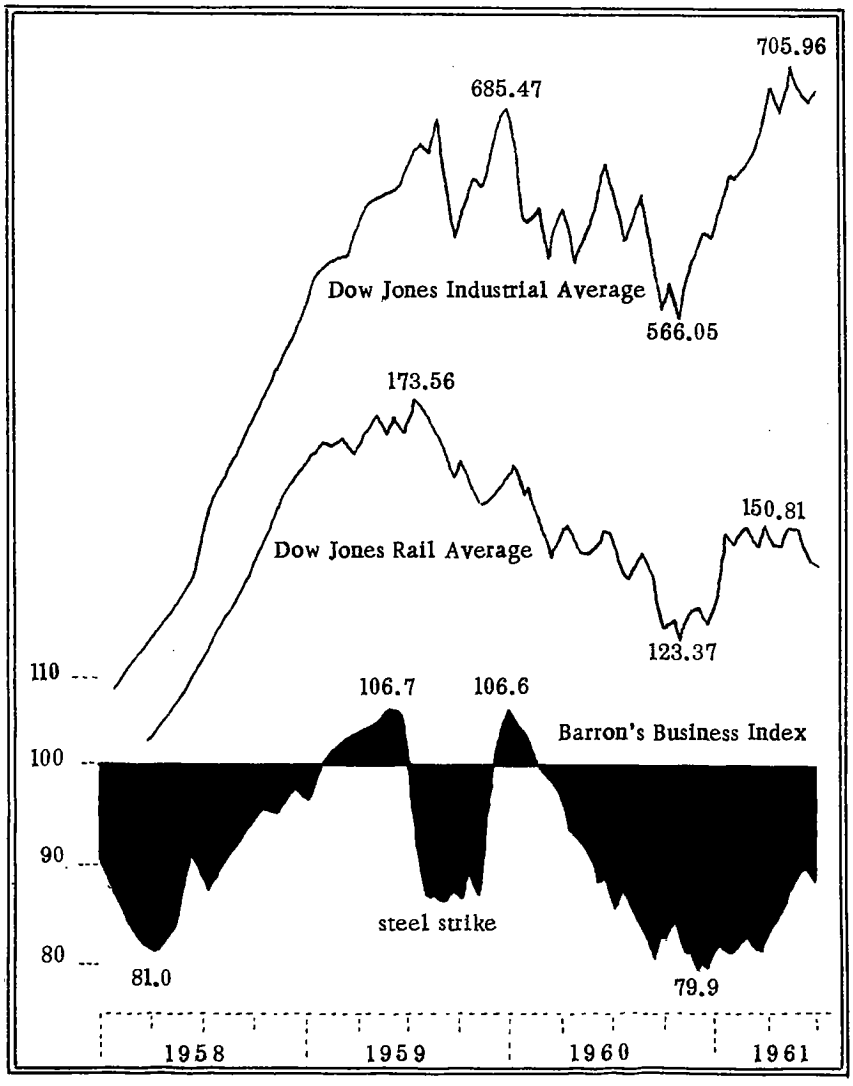
Following the July, 1959 Rail peak that Average declined to a November low of 146.65. From there Rails rallied, and by January 5, 1960, Rails reached a recovery high of 160.43. Rail volume, which had been averaging about 75 thousand shares per day during December, 1959, ran as follows: Dec. 31, 1959 - 140 thous., Jan. 4, 1969 - 157 thous., Jan. 5 - 152 thous. (this was the high day for the Rail Average), Jan. 6 - 163 thous., Jan. 7 - 64 thousand.

Subsequently, the Rail Average retreated to a March 8 low of 138.18. Again Rails rallied -- this time to a March 24 high of 146.56, and the same phenomenon was seen again as Rail volume rose on March 23 to 124 thousand shares. During the next six months the Rail Average sank to a September, 1960 low of 123.37.

In view of the 1959 and 1960 Rail action, it is interesting to observe the same process continuing. I have shown Rail volume (under total volume) on the page 1 chart in this Letter. At the March 22, 1961 Rail peak of 150.81, Rail volume rose to 292 thousand shares. On the second Rail peak of 148.02 (May 17) Rail volume rose to 201 thousand shares. On the most recent minor Rail peak of 142.48 (July 6) Rail volume expanded to 120 thousand shares. Following each surge in Rail volume the carriers declined.

Now, what can we deduce from all this history? It seems to me that the following statement is warranted: sharply higher prices for Rails over the last two years have been accompanied by a day to a few days of abnormally high Rail volume. Whenever this volume has appeared, the Rail Average subsequently declined. The conclusion is that the Rail Average has been under distribution for the past two years, and that the heaviest Rail selling has taken place under the guise of periodic "strong" Rail markets.

BUSINESS AND THE AVERAGES "Consciously or unconsciously," wrote Hamilton, "the movement of prices reflects not the past but the future. When coming events cast their shadows before, the shadows fall on the New York Stock Exchange." No event (except perhaps war) casts a greater shadow on the Exchange than forthcoming periods of business expansion or contraction. The truth of this statement can be verified by a glance at the accompanying chart of the D-J Averages superimposed upon Barron's Business Index. The components of Barron's Business Index are: (1) steel activity, (2) petroleum production, (3) coal production, (4) carloadings, (5) electric power output (all are adjusted for seasonal and population trends).



In October, 1957, the stock market bottomed out (during the recession), following which, the great market surge into late 1959 occurred. From its 1958 recession low of 81.00, Barron's Business Index rose steadily to a mid-1959 peak of 106.7. The steel strike interrupted the nation's economy temporarily, but after the strike settlement Barron's Index again climbed above the 106 level.

In March, 1960, the market gave a bear signal, and by December of that year Barron's Index had plunged to its lowest level since 1949 (79.9 -- see chart). The upward progress of the Index since then has been unspectacular. On the week of June 19, Barron's Index struck a recovery high of 89.3 (which was 16% under the 1959 high), and the 89.3 mark has not since been bettered (last week's figure - 87.2).

Two factors may have been responsible for the sluggish performance of Barron's Index since June 19: (1) the decline of the Rail Average, reflecting unsatisfactory carloadings, (2) the July vacation period. The vacation is now over, but the Rails are acting as poorly as before. In my opinion, unless Rails can start moving towards, and eventually

over, the 150.81 high, Barron's Index should begin running into trouble.

STOCKS Ten of the seventeen stocks in our "continuing study group" are now under their long-term or 30-week moving average with one (General Motors) right on the edge (M. A. on G. M. is 44 7/8). This is the poorest showing yet.

Alcoa has dropped under its moving average (M. A.) which is now 73 1/2. Important support for Alcoa, at 70, was cracked on July 18. I now list the stock as bearish.

Letter 147 termed Eastman Kodak as "tired" and "trendless". Nothing has changed since then. E. K. has been holding below its M. A. of 111 and above its February, 1961 low of 104 1/4. A penetration either way would be meaningful.

Goodyear was recommended for purchase in Letter 135 around 36; it was again recommended in Letter 144 at 41-42. The stock has acted considerably better than the market, but I would now put "stop-losses" around 41 3/4.

The chart in Letter 147 showed the "head-and-shoulders" distribution pattern in New York Central, and I said that I believed the October, 1960 low of 14 3/4 would be "tested" again. This week CN got within 3/4 of a point of the 1960 low. My guess is that if CN cracks the 14 3/4 level, it may go the way of the New Haven.

The chart of General Electric illustrates the interesting relationshop between a stock and its M. A. GE rallied in December, March and June, but turned down each time the stock ran into the area of its own descending M. A. At the April low I thought that the odds favored a "double bottom", and I recommended purchases around 60-61. Thesubsequent rise took GE to 68 -- then back to this week's low of 62. The action has been discouraging, and I would sell G. E. on a violation of 60 (if you have not sold it already).

The current issue of Forbes Magazine (Forbes has the largest circulation of any financial magazine) contains a "lead-off" story which sings the praises of Litton Industries. In the face of this bullish publicity, it is interesting to see the exceedingly "toppy" formation which has been formed by this "glamour stock". Note the classic diminution of volume in the "head-and-shoulders" pattern on the chart. At the right shoulder volume was running under that which appeared at the May high (the "head") and well under the previous March peak (the "left shoulder"). Short sales may be put out with the stipulation that they are to be covered if the stock goes to a new high (above 135 3/4). A break below 112 would mean that the stock has seen its high for a long time to come (chart of Litton courtesy of Traders Research, P. O. Box 6185, Lambert Airport, Mo.)

According to my friend Eliot Janeway, the recent Canadian devaluation will mean a "windfall" of from 4 to 8% in the profits of Canadian gold companies. Moreover, says Janeway, the Canadian gold companies were among the first to learn to live under the present earnings sqeeze. Firmness is now seen in the gold stocks, and the Canadian gold average appears to have hit bottom and turned up.

Written Wednesday, July 19, 2 P. M.